Office of Chief Counselwi
Internal Revenue Service

memorandum

CC: [redacted]:TL-N-990-99
[redacted]

date:

to: Chief, Examination Division, [redacted]
Chief, Coordinated Examination Branch
Attn.: [redacted], Case Coordinator, [redacted]

from: Assistant District Counsel, [redacted]

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subject: [redacted]
Application of Claim of Right Doctrine To Environmental Remediation Expense Under Section 1341.

DISCLOSURE STATEMENT

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You have informally requested our legal advice on the availability of the Section 1341 alternate tax computations for the taxpayer's taxable years [redacted], [redacted], and [redacted]. At the request of your team coordinator, our attorney [redacted] met with the taxpayer's Director of [redacted], [redacted] and his associate, [redacted]. Our analysis is based on the discussions occurring during that meeting and the taxpayer's memorandum to your team coordinator dated [redacted]. The taxpayer has recently provided additional arguments in an undated supplemental memorandum, which we have also considered.

ISSUE:

Whether the taxpayer may treat environmental clean-up costs paid and otherwise deductible in the taxable years [redacted], [redacted] and [redacted] as "item[s]... included gross income for prior taxable years" that the taxpayer has "restored," for purposes of computing its tax under Section 1341.

CONCLUSION:

The alternate tax computations under Section 1341 are not available to the taxpayer since payments for environmental clean-up do not constitute restored items of gross income held under a claim of right.

FACTS

During the course of the examination of its [redacted] through [redacted] tax returns, [redacted] submitted an informal claim for an affirmative adjustment to its tax liability. This informal claim is based on the application of the claim of right relief provision of § 1341 of the Code[1]. The taxpayer confirmed that it has submitted the claim on the advice of its independent tax consultant, a "Big Five" accounting firm that is marking this idea. The issue implicates about $[redacted] in tax.

[redacted] manufactures and sells [redacted] products. During the taxable period [redacted] through [redacted], [redacted] incurred approximately $[redacted] of deductible environmental remediation expenses for the disposal of waste. The contamination requiring remediation occurred during its manufacturing of [redacted] from [redacted] to [redacted]. The taxpayer claims that the remediation expenses are properly characterized as additional "cost of goods sold" relating to the products sold in the earlier period, since the expenses relate to the manufacture of products sold by [redacted] during [redacted] through [redacted]. Obviously,

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[1] The facts upon which the claim is based have been provided by the taxpayer, but have not yet been verified by the examining agent. These facts are assumed to be true solely for purposes of our opinion on the narrow legal issue presented.

[2] The team coordinator has not necessarily accepted the proposition that remediation expenses are properly classified as cost of sales rather than a non-inventoriable business expense. We will assume these expenses to be properly includible in cost of sales in order to consider whether Sec. 1341 applies in this case.

these expenses were not deducted against gross sales on the tax returns filed for the earlier years. The taxpayer argues now that [redacted] overstated its taxable income and overpaid tax for most of the period between [redacted] to [redacted] because it did not account for (or more accurately, reserve for) the remediation cost on a current basis. It claims that absent the application of 1341, [redacted] will suffer a permanent economic cost, even after the deduction for remediation expenses for the current taxable periods. The taxpayer claims that this loss is attributable to the decline in applicable tax rates between the years of income inclusion ([redacted] through [redacted] and the years of deduction ([redacted] through [redacted]).

LAW and ANALYSIS:

The claim of right doctrine requires that a taxpayer currently include items in gross income when he has received or taken such items under claim of right without substantial restrictions upon disposition. North American Oil Consolidated v. Burnet, 286 U.S. 417 (1932). In United States v. Lewis, 340 U.S. 590 (1951), the application of the claim of right doctrine resulted in the taxpayer reporting certain amounts in income in 1944 although information discovered in a later year required him under compulsion of a court judgment to refund some of the amounts previously received. The Lewis Court held that the subsequent refunding of these items did not permit a recomputation of the tax liability for 1944, the year of inclusion. Rather, the Court held that the taxpayer should deduct the amount of the returned items as a loss in the later year of repayment. Due to a reduction in the effective tax rates from the year of inclusion to the year of deduction, the taxpayer suffered a net tax loss.

To mitigate the sometime harsh result of the Lewis decision, and a tax system based on annual accounting rather than transactional accounting, Congress enacted Sec. 1341 in 1954. Under Section 1341, the tax savings attributable to repayment of an income item is to be the greater of the amounts calculated under two approaches:

> Under the first approach, the taxpayer merely calculates its tax liability after having deducted the repayment in arriving at taxable income. §1341(a)(4).
>
> Under the Second approach, tax is computed for the year of repayment without deduction, but with a reduction in tax liability equal to the reduction in tax that would have

occurred in the year of receipt had the amount of the repayment been excluded from income. §1341(a)(5).

There are three requirements for taxpayers who wish to avail themselves of §1341 relief:

1341(a)(1) an item was included in gross income for a prior taxable year (or years) because it appeared that the taxpayer had an unrestricted right to such item;

1341(a)(2) a deduction is allowable for the taxable year because it was established after the close of such prior taxable year (or years) that the taxpayer did not have an unrestricted right to such item or to a portion of such item; and

1341(a)(3) the amount of such deduction exceeds $3,000.

The taxpayer claims that it satisfies each of these requirements and is therefore eligible to reduce its tax liability. With respect to the first statutory requirement, the taxpayer claims that [redacted] included items in gross income in prior taxable years by understating waste disposal costs which should have been included in prior year's cost of goods sold. In support it cites United States v Skelly Oil, 394 US 678 (1969); North American Oil Consolidated v Burnet, 286 US 417 (1932); Treas. Reg. §1.61-3(a); GCM 35,403 (July 16, 1973); and In Re Lilly, 76 F.3d 568 (4th Cir. 1996). These sources provide no guidance that would support the taxpayer's position on its facts, to the extent they are at all relevant to the instant they support the disallowance of §1341 relief[3].

The taxpayer purports to have met the first requirement of Sec. 1341 because, as of the close of the each of the respective tax years [redacted] through [redacted], it "appeared" that [redacted] had accrued and accounted for all waste disposal costs. Following this logic, the taxpayer claims that it therefore "appeared" that [redacted] had an unrestricted right to use the gross income from [redacted] through [redacted], which had not yet been diminished by environmental clean-up costs that it was required to pay in [redacted], [redacted], and [redacted].

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[3] For example, GCM 35403 clearly rejects the argument that §1341 operates with reference to the Reg. 1.61-3 definition of gross income. This §1.61-3 argument is more fully addressed below.

With respect to the second statutory requirement, the taxpayer claims that after the close of the prior taxable years, it was established that [redacted] did not, in fact, have an unrestricted right to the gross income reported those years, because [redacted] incurred additional environmental clean-up costs which it was required to pay in [redacted], [redacted], and [redacted]. Clearly the amount of the environmental clean-up cost deduction exceeds $3,000 to satisfy the third requirement.

PAYMENTS FOR ENVIRONMENTAL CLEAN-UP COSTS DO NOT CONSTITUTE THE RESTORATION BY THE TAXPAYER OF AN ITEM OF GROSS INCOME INCLUDED IN GROSS INCOME FOR A PRIOR YEAR UNDER A CLAIM OF RIGHT

The taxpayer offers a contorted reading of the statute to treat the payments of remediation expenses as the restoration of items of gross income received or accrued under claim of right in prior years. The language of the statute indicates that the intended relief of §1341 is for a taxpayer who reported an "item" in "gross income" for a "prior taxable year" if it is established after the close of that taxable year "that the taxpayer did not have an unrestricted right to such item". Sec. 1341(a). The taxpayer attempts to fit the remediation expenses into the classification of a restored item of gross income by using the definition of gross income found in Treas. Reg. 1.61-3. Treas Reg. 1.61-3(a) states that for manufacturers, "'gross income' means the total sales, less the cost of goods sold." While cost of sales clearly constitutes a component of the gross income computation, the taxpayer over reads the Treas. Reg. by suggesting that the remediation costs were items previously *included* in gross income under a claim of right.

The statute is clear that section 1341 relief is restricted to items of income previously *received* and reported by a taxpayer who must repay those *same* items in a subsequent year. See, Smith Est. v. Commissioner, 110 T.C. 12 (1998). In other words, it seems that a better reading of the statute in the present scenario is that "gross income" for purposes of § 1341(a)(1) must means gross *receipts* which, of course, are included in the *computation of gross income.*

In its supplemental memorandum, the taxpayer calls for a broad reading of §1341, citing Van Cleave v. United States, 718 F2d 193 (6th Cir. 1983). We feel strongly that no such expansive interpretation is warranted. At the heart of this controversy is [redacted] deduction for expenses associated with environmental clean-up. It is universally accepted as a basic tenet of tax law that

when dealing with deductions, a strict application of the statute is warranted. Corn Products Refining Co. v. Commissioner 55-2 USTC ¶9746, 350 U.S. 46, 52 (1955); Kappel v. United States 68-1 USTC ¶9299, 281 F.Supp. 426, 431 (W.D. Pa. 1968), aff'd, 437 F.2d 1222. The statute at §1341 explicitly singles out taxpayers who have included an amount in their gross income, paid taxes on that amount, and subsequently were required to *restore* that amount to another. Van Cleave, which involved a corporate officer's repayment of income determined by the Internal Revenue Service to be excessive; falls within this category. [redacted] does not.

Also in its supplemental memorandum, the taxpayer cites The First National Bank of Elkhart County v. U.S., 330 F.Supp. 975, 977, (N.D. Ind. 1971), to suggest, through deductive reasoning, that any expenses considered in the computation of gross income are afforded §1341 treatment because of the §1.61-3 definition. We are constrained to note that First National Bank is a District Court case that has not been picked up by the commercial tax reporter services. As such, we suspect that First National Bank is not widely viewed as authoritative in the tax community. Nevertheless, a reading of the *full* opinion in First National Bank illustrates that the case actually supports the government's position in the present case.

In First National Bank, a Schedule C optometrist entered into an employment contract with another optometrist. The employee was to receive a salary equal to a fixed percentages of the taxpayer's net profits from the optometry business. After several years it was disclosed that the taxpayer's accounting method caused him to have underpaid the employee for a thirteen year period. He later agreed to pay the employee $25,000 for the past shortages in salary. He sought §1341 treatment for the $25,000 payment in the current tax year in a refund action against the IRS. The government filed a motion to dismiss on several grounds, including:

> The salary was not included in *gross income*, but rather in the [employee's] *adjusted gross income*.

While we question the way in which this issue was framed by the government and the court in First National Bank, the court's reasoning was clear in ruling for the government. The court pointed out that, as in the [redacted] situation, the funds included in gross income remained unrestricted, the obligation of the taxpayer's to make payments to third parties notwithstanding. The court pointed out that in contrast §1341 would apply if the

taxpayer had mistakenly billed and overcharged one of his optometrist clients, paid taxes on the amount received, and then recompensed the client in a subsequent period. Section 1341 would be given effect as the ***repaid*** item would have been retained under a claim of right. As in First National Bank, [redacted] did not *repay* items retained under a claim of right.

The taxpayer's reasoning is also flawed since its ignores the fact that §1341 requires a direct relationship between the item included in gross and the deductible repaid item. In the [redacted] situation, the sale of [redacted] from [redacted] through [redacted] and the payment for environmental cleanup were two separate and distinct transactions; there was not the requisite transactional nexus for §1341 application. The Tax Court has held that for §1341 to apply, the deductible restored items must be directly connected to the items that were previously included in gross income. Uhlenbrock v. Commissioner, 67 T.C. 818 (1977). In interpreting §§ 1341(a)(1) and 1341(a)(2), the Court requires that the obligation to repay an item of income arises out of specific circumstances, terms, and conditions of the same transaction in which the amount was originally required to be included in income. See, Pahl v. Commissioner, 67 T.C. 286; Blanton v. Commissioner, 46 T.C. 527 (1966), aff'd 379 F.2d 558 (5th Cir. 1967).

In Usher v. Commissioner, T.C. Memo 1980-180, the taxpayers received payments from two people under certain real estate option contracts totaling $200,000, which they were required to include in gross income for tax years 1973 and 1974. In 1975, the taxpayers paid $200,000 to a third person in settlement of a breach of contract action involving the same piece of real estate but arising out of a separate option contract from those which yielded the income in 1973 and 1974. The Tax Court held that § 1341 was not available because the settlement arose out of a contract different from those which had produced the previously reported $200,000 in gross income. As in Usher, the payments to the environmental remediation contractor in [redacted], [redacted] and [redacted] were made under contracts that were wholly unrelated to contracts for the sale of [redacted] that produced income for the taxpayer from [redacted] through [redacted]. Section 1341 does not apply here.

SECTION 1341(a) DOES NOT APPLY SINCE [redacted] AND [redacted] HAD AN "ACTUAL" UNRESTRICTED RIGHT TO INCOME RATHER THAT THE "APPEARANCE" OF AN UNRESTRICTED RIGHT

Even if the restoration costs could be view as items previously included in gross income, the taxpayer's arguments also fail. Treas. Reg. 1.1341-1(a)(1) provides that "income included under a claim of right" means an item included in gross income because it APPEARED FROM ALL THE FACTS AVAILABLE IN THE YEAR OF INCLUSION that the taxpayer had an unrestricted right to such item [Emphasis added]. In this case, [redacted] reported income from [redacted] sales, not because it *appeared* to have an unrestricted right to such income, but rather because it had an *absolute* right to such income. Section 1341 does not apply if the taxpayer included income under an *absolute* right. Rev. Rul. 58-226, 1958-1 C.B. 318. In Usher v. Commissioner, *supra*, the Tax Court observed that § 1341 "does not apply where the taxpayer did, in fact, have an unrestricted right to receive the amount in the prior year and the obligation to repay arose as a result of subsequent events."

During the years [redacted] through [redacted], there was no legal obligation that required the taxpayer to remediate its contaminated facilities. Viewed another way, no event of liability for environmental clean-up had occurred that would have permitted a deduction for clean-up costs under the all events test of §461 for those prior years. As of the close of those tax years, the taxpayer had, as a matter of fact and law, the unrestricted right to the sales proceeds. Thus, as of the close of those taxable years, the taxpayer had an *absolute* right to retain its gross income from sales. The fact that subsequent litigation or government regulation created a liability for environmental clean-up does not make §1341 available to the taxpayer. A later accruing liability does not in any way establish that the taxpayer did not, in fact, have an unrestricted right to the sales income at the close of the taxable year in which earned[4].

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[4] A recent District Court opinion dealing with a public utility is at odds with the IRS's "Subsequent Event Theory" discussed herein and supported by the Tax Court. See, Dominion Resources, Inc v. United States, 83 AFTR2d ¶ 99-543 (EDVA 1999). We expect that in light of the Services' success in the Tax Court in using this theory, the Service will continue to follow the Court's holding in Blanton v. Commissioner, 46 T.C. 527 (1966),

THE COST OF GOODS SOLD COMPONENT OF THE GROSS INCOME COMPUTATION HAS NO RELEVANCE IN DETERMINING WHETHER SECTION 1341 RELIEF IS AVAILABLE.

Revenue Ruling 72-28 further supports a position that Sec. 1341 applies only to the gross receipts component of gross income and not the cost of sales component. The taxpayer in Rev Rul. 72-28 was a public utility company that was subjected to a contingent rate increase on its gas purchases in 1969. The taxpayer passed these rate increases on to its customers dollar for dollar by collecting a corresponding amount of the increase in the purchased gas expense[5] from the customer. The taxpayer properly reported the additional amount collected as gross income in 1969. It, of course, deducted the additional cost of gas as a cost of goods sold in 1969 as well.

During 1970, the taxpayer received refunds from its suppliers of some of the cost increases paid to them in 1969. The taxpayer included these supplier refunds in its gross income for 1970. Also in 1970, the taxpayer made corresponding equivalent refunds to its customers. The taxpayer sought §1341 treatment for the amounts repaid to its customers in 1970 and deductible for that year. The issue in Rev Rul 72-28 was whether §1341 applied, even though for 1969 the taxpayer had increased its cost of sales by amount equal to the increase in gross receipts from its customers, causing no net effect on gross income.

The Service ruled that §1341 applied to refunds made by the public utility company to its customers, for which it could claim a deduction in the subsequent year. The Service held that the fact that the taxpayer had increased cost of sales in prior years under a claim of right "has no relevancy in determining the application of Sec. 1341" For the same reason, we submit that [redacted]'s increases to cost of sales for [redacted], [redacted] and [redacted] do not implicate §1341 treatment, even if the taxpayer may be able to prove some transactional nexis with gross receipts for prior taxable years.

An example in 502 -1st T.M., Gross Income: Tax Benefits, Claim of Right and Assignment of Income illustrates this point:

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[5]In essence, the taxpayer's gross receipts and cost of sales increased by the same amount for [redacted], leaving gross income as defined by Re. 1.61-3 uneffected.

> Example: In 1995, U's supplier increases the cost of gas by $500,000; U increases cost of inventory, and thus cost of goods sold, by $500,000. U also increases charges to customers by $500,000, and includes the extra $500,000 in gross receipts and in gross income. U's 1995 taxable income is the same as it otherwise would have been. In 1997, U's supplier refunds $500,000 to U, which U refunds to its customers. U must include the $500,000 in gross income and is allowed to deduct the $500,000 of customer refunds. U's 1997 taxable income is the same as it otherwise would have been. U is permitted to use Section 1341 even though U deducted $500,000 in 1995 as part of cost of goods sold. Assume that U's 1995 tax bracket is 34% and that U's 1997 tax bracket is 15%. Under Section 1341, the $500,000 deduction in 1997 in effect reduces U's 1997 tax liability by $170,000 ($500,000 X .34). U's 1992 taxable income without regard to the $500,000 deduction is $500,000 more than it would have been without the refunds, and thus U's 1997 tax liability increases by $75,000 ($500,000 X .15). Thus, U's 1997 tax liability is $95,000 ($170,000 - $75,000) less than it would have been had there been no supplier charges, customer charges, supplier refund, or customer refunds. This is so even though U's 1995 and 1997 taxable incomes were unaffected by the existence of those transactions. Maule, Gross Income: Tax Benefits, claim of Right, and Assignment of Income, 502-1st T.M. pg. 171.

Chief Counsel reviewed the conclusion in Rev. Rul. 78-28 which created an apparent windfall for taxpayers as the above example illustrates. In GCM 35403, Counsel addressed the Reg. 1.61-3 issue by stating that the term "included in gross income" must mean "included in the computation of gross income." In GCM 35403, Chief Counsel emphasized that §1341(a)(1) does not refer merely to "gross income" but uses the phrase "an *item* of gross income." The importance of this distinction is reinforced by §1341(a)(2) which states that a deduction is allowed in a later year because it is established that the taxpayer did not have an unrestricted right to the ***item***. It follows that it must be possible to identify the various component items of gross income in order for §1341 to have any vitality. The GCM states that use of the Treas. Reg. 1.61-3 definition would eliminate the concept of an ***item***. Accordingly, we read GCM 35403 to mean that the cost of goods sold component must be ignored for purposes of §1341.

SECTION 1341(b)(2) PRECLUDES THE TAXPAYER FROM USING SECTION 1341 TO COMPUTE ITS TAX LIABILITIES FOR [redacted], [redacted], AND [redacted].

It also seems apparent that Sec. 1341(b)(2) precludes this taxpayer, a manufacture and seller of inventoriable goods, from using §1341 to determine its tax liability. Section 1341 does not apply to deductions attributable to repayment of items included in gross income in a previous year on account of sale or disposition of inventory. Sec. 1341(b)(2); Regs. Section 1.1341-1(f)(1). The taxpayer is a manufacturer of goods; it maintains inventory of these manufactured good for sale in the ordinary course of its business.

The taxpayer attempts to sidestep the inventory exception of §1341(b)(2) by arguing that the exception applies only to sales returns and allowances, sales discounts, and similar items. The taxpayer claims that the events that require a manufacturer such as [redacted] and [redacted] to restore prior reported income pursuant to a court judgment or out of court settlement do not constitute the types of events that fall within the inventory exception. To state the taxpayer's position another way, the §1341(b)(2) exception does not apply to payments which represent a splitting or division of profits, even if the profits have their origin in the sale of inventoriable goods. As authority, the taxpayer cites Killeen v. United States, 1 USTC ¶ 9351 (S.D. Cal. 1963), as being analogous to the [redacted] situation. Killeen, an unreported District Court case, does not support the taxpayer.

In Killeen, a manufacturer and a designer entered into a joint venture agreement to produce and market a speed control device. The joint venture agreement provided that the *net profits* would be divided equally between the manufacturer and the designer. Net profits were defined in the joint venture agreement to be gross receipts minus certain enumerated cost of manufacturing. The manufacturer collected all of the receipts and retained all of the net profits in contravention of the agreement. The designer later obtained a judgment in state court for its portion of the net profits that had been wrongfully withheld. The manufacturer then paid over the required share of profits and claimed §1341 relief for the deductible payment to the designer. The Service tried to invoke §1341(b)(2) to preclude the taxpayer from availing itself of § 1341 by arguing that the payment to the designer had previously been included in gross income "by reason of the sale or other disposition of stock in trade". The District Court held that the amount paid to the designer in satisfaction of the judgment was *net profits* previously reported

by the manufacturer and *not* items included in gross income on account of the sale of inventory.

The taxpayer views the Killeen situation as an exception to the §1341(b)(2) exception. The only *true* exception to that provision applies to public utilities. In fact, §1341(b)(2) simply does not come into play in the Killeen scenario. The facts of Killeen show that the issue pertained to the division of net profits under a contractual arrangement, after the taxpayer had reported all of the profits in his gross income. The case did not deal with sales returns and allowances, sales discounts, and the like. Therefore, there was no §1341(b)(2) issue for the Court to consider[6].

Killeen is clearly distinguishable from the [redacted] and [redacted] case since there is no income splitting occurring here, although the taxpayer has suggested, unrealistically, that payments to the remediation contractor constituted the splitting of profits. In any event, the taxpayer's reliance in Killeen illustrates the frivolity of its entire §1341 argument. The arguments that the taxpayer must make to avoid §1341(b)(2) actually create a non-sequitur with its argument that §1341 applies at all. In order for the taxpayer to obtain §1341 relief in the first instance, it must establish that the remediation expenses constitute costs of goods sold in order to fit into the § 1.61-3 definition of gross income. To prevail on this point, the taxpayer must prove that the clean-up costs were, in fact, cost of manufacturing [redacted] from [redacted] to [redacted]. If the taxpayer is successful in this regard, the remediation costs should reasonably be treated as cost of manufacturing, i.e. inventory costs. If that is the case and the costs are inventoriable, §1341(b)(2) precludes the taxpayer from using §1341 to compute its income tax liability. The taxpayer can hardly argue that the remediation expenses are cost of goods sold on one hand and the repayment or splitting of gross revenue on the other.

As can be inferred from the foregoing discussion, there are no decided cases or administrative rulings on all fours with this issue. However, Mair Brewing Company v. Commissioner, T.C. Memo. 1987-385 illustrates that the Tax Court does not consider business expenses as items that were "included in gross income" even if such expenses constitute costs of goods sold. The Tax Court distinguished Killeen and other similar cases dealing with

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[6] In our view, the §1341(b)(2) issue probably should not have been advanced by the government.

commissions and other selling expenses, noting that in those cases there was a sharing of the sales or purchase price that taxpayers had included in gross income in prior years and that they were required to repay in later years. Section 1341 applies in those cases. For the foregoing reasons, Section 1341 does not apply to the remediation payments in this case.

RECOMMENDATION:

[redacted]

This concludes our advice and recommendation. Please feel free to call Attorney [redacted] with any additional questions you may have. We are forwarding a copy of this advice to the Assistant Regional Counsel (Tax Litigation) [redacted] and to the Office of Assistant Chief Counsel (Field Service)(CC:DOM:FS) for mandatory 10 day post review. To assure that the National Office has had sufficient time to review our advice, we request that you refrain from taking any action with respect to the taxpayer's claim prior to May 7, 1999.

[redacted]
Assistant District Counsel

cc: Assistant Regional Counsel (Tax Litigation) [redacted]
Office of Assistant Chief Counsel (Field Service)(CC:DOM:FS)